Before the

FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the matter of	
Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers	CC Docket No. 00-256
Federal-State Joint Board on Universal Service	CC Docket No. 96-45
Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate-of-Return Regulation	CC Docket No. 98-77
Prescribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers	CC Docket No. 98-166

COMMENTS OF NRTA, OPASTCO AND USTA

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The National Rural Telecom Association (NRTA), the Organization for the Promotion and Advancement of Small Telecommunications Companies (OPASTCO) and the United States Telecom Association (USTA) (the Associations)[1] submit these joint comments in response to the Commission's Further Notice of Proposed Rulemaking (FNPRM) in the above-captioned proceedings.[2] NRTA is an association of incumbent local exchange carriers (ILECs) that obtain financing under Rural Utilities Service (RUS) and Rural Telephone Bank (RTB) programs. OPASTCO is a trade association representing over 500 small ILECs serving rural areas of the

[1] The Associations participated in the earlier phase of these proceedings as members of the Multi-Association Group that originally requested a comprehensive resolution of issues affecting rate-of-return-regulated (ROR) ILECs. The Commission decided the access, universal service and ROR issues raised by the MAG group and deferred the incentive regulation and related issues for a further rulemaking proceeding. The three Associations are participating jointly in the reconsideration and further rulemaking proceeding.

[2] *See Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, CC Docket No. 00-256, *Second Order and Further Notice of Proposed Rulemaking*, 16 FCC Rcd 19613 (2001) (FNPRM).

United States. All of the members of both associations are rural telephone companies as defined in 47 U.S.C. §153(37). USTA represents more than 1,200 telecommunications companies worldwide that provide a full array of voice, data, and video services over wireline and wireless networks.

I. INTRODUCTION AND SUMMARY

The stated purpose of the FNPRM is to "explore options for developing an alternative regulatory structure that would be available to those rate-of-return carriers electing it," taking into consideration "the widely varying operating circumstances of rate-of-return carriers, the implications of competitive and intrastate regulatory conditions on the options available, and the need to facilitate and ensure the deployment of advanced services in rural America." The Commission will also consider changes to its "all-or-nothing" rules recommended in the Multi-Association Group (MAG) plan, further pricing flexibility for ROR carriers and potential changes to Long Term Support (LTS) in mid-2003, when the Carrier Common Line (CCL) charge will be eliminated.

In line with the Commission's wise recognition and the full record on ROR ILECs' diversity, the Commission should adopt an entirely optional alternative regulation plan, which will enable carriers to suit their form of regulation to the challenges of their service areas. Indeed, optionality should be the primary touchstone of any decision the Commission makes in this phase of this proceeding. All customers will benefit from adoption of non-mandatory opportunities for carriers to increase their efficiency when their markets are ready for incentive regulation. But mandating incentive regulation before a carrier is ready risks sacrificing the carrier's incentives to invest in evolving network capabilities and services, quality of service and reasonably comparable rural and urban rates and services.

Since the diversity of commonly-owned ROR service areas is no different from the range of characteristics and circumstances faced by small independently-owned ILECs, optional alternative regulation should be available to them on a study-area-by-study-area basis. The bases for earlier decisions that assessed the balance of purely theoretical cost-shifting risks vs. the benefits of appropriate regulation for particular individual serving areas have dramatically changed. The Commission has routinely granted waivers because the risk of "gaming" has not presented a concern in real fact situations and the Commission can readily prevent serial changes. Cost shifting has not materialized from commonly-owned average schedule and cost companies or from recent long periods with affiliates operating on price caps and ROR because the all-or-nothing rules prevent a satisfactory resolution. Regulatory safeguards and the change in national policy to competition (including growing wireless substitution) and deregulation have transformed the risk/benefit equation since the pooling and price caps decisions.

Whatever alternative regulation the Commission adopts should not jeopardize regulatory options that have demonstrated their ability to achieve the objectives of Congress and the Commission. The Commission is correct that ROR has worked well in extending service to rural America. An important example of the existing, time-tested and proven regulatory choices that must be preserved is the option for ROR carriers to choose to perform cost studies or operate under average schedules. The Commission has held that average schedule regulation provides incentives for efficiency like price caps, and has also recognized the value of cost studies that identify costs with precision. Both should remain available to meet the diverse needs of diverse ROR carriers.

Section 61.39 is another option with a track record of reducing rates and providing the discipline of regulatory-lag-based incentives. It should remain available for common line or traffic sensitive tariff purposes. To preserve the two-year period, it may make sense for §61.39 carriers to freeze their ICLS on a per-line basis for each two-year period before resetting rates based on historical costs. The Commission should also remove its artificial restriction of §61.39 to National Exchange Carrier Association (NECA) subset 3 carriers and carriers with less than

50,000 lines. The Commission's explanation for imposing those restrictions was flimsy, at best, and could not pass the test of the subsequent Alltel case or survive the change in the rule's role: The purpose of §61.39 has matured from merely reducing administrative burdens for small carriers to providing a regulatory alternative that has performed well. It should be kept and extended.

In addition, the Commission should ensure that pooling remains feasible for carriers that need the risk sharing and tariff expertise provided by the NECA pools. NECA will further explain its ability and willingness to adapt its pools to optional incentive regulation. Enabling carriers to choose incentive regulation and continue pool membership will help keep the pool healthy for small carriers that rely heavily on pooling.

Finally, the Commission should grant immediately regulatory flexibility to ROR carriers to enable them to respond to competition. Wireless competition is growing fast and even increasingly becoming a substitute for wireline service, jeopardizing the ILEC's residential customer base. Moreover, with only a few large volume business users, at best, other competitors' business-targeted competition can reduce small ILECs' revenues severely. ROR ILECs need flexibility for geographic deaveraging and offering volume and term discounts and contract pricing before the damage is already done. Competition triggers are simply not a meaningful way to safeguard customers or ensure that ROR ILECs can maintain quality service. Flexibility must be available without leaving the NECA pools both because of small ILECs' dependence on pooling and the need to allow lower-cost ILECs flexibility in the pools to keep the pools from draining and losing efficacy for those who need pooling most.

II. ANY INCENTIVE PLAN MUST BE OPTIONAL FOR ALL CARRIERS

A The Diversity of ROR Carriers and their Customers' Need for Comparable Network Capabilities and Services Preclude Forcible Conversion to Any Incentive Regulation Plan

The Associations commend the Commission for recognizing that ROR carriers are diverse, both in the access charge reforms adopted in the MAG Order and in proposing here to design an alternative regulation method that carriers may elect. As Chairman Powell pointed out in his separate statement, "[t]he Commission has always recognized ... that 'one size does not fit all' when addressing the needs of rural and small companies." Similarly, the FNPRM correctly observes (¶227) that, "[g]iven the wide variations among rate-of-return carrier operating conditions, we believe it would be extremely difficult to establish a mandatory alternative regulatory plan for all rate-of-return carriers." The Commission should proceed upon that sound premise, notwithstanding AT&T's efforts to compel some undefined larger carrier subgroup to elect incentive regulation regardless of whether it suits an individual carrier's or its customers' needs.

There is ample factual basis for continuing to avoid the "one-size-fits-all" fallacy for RORs by adopting an entirely optional incentive plan. The Rural Task Force (RTF) demonstrated in White Paper #2 that small and rural ILECs differ widely from price cap companies and among themselves. The FNPRM notes (¶ 4) that the Commission has "consistently" taken their diversity into account, including the small share of the nation's access lines that they serve, individually and in the aggregate, their typically small size, geographic concentration, low-customer-density and, thus, higher-cost service areas. A mandatory incentive plan is especially dangerous for ROR companies because, as the FNPRM observes, these carriers generally "rely more heavily on revenues from interstate access charges and universal service support."[3] They also are the most likely to fall behind in achieving increased network capabilities and advanced services.[4]

[3] FNPRM at ¶ 4.

[4] *See Inquiry Concerning the Deployment of Advanced Telecommunications Capability to All Americans in a Reasonable and Timely Fashion, and Possible Steps to Accelerate Such Deployment Pursuant to Section 706 of the*

AT&T has never demonstrated why any ROR ILEC should be forced into an incentive mold, let alone why such a heavy-handed regulatory fiat would benefit consumers. The RTF paper shows that they are not like the huge price cap carriers, with their large, dense urban cores. Instead,

> [t]he Rural Task Force found that the average population density in areas served by rural carriers is only about thirteen persons per square mile, compared to 105 persons per square mile in areas served by non-rural carriers. Thus, rural carriers must deploy more transmission facilities to serve their customers and usually employ smaller switches than do carriers serving more densely-populated areas.

Nor are even the largest of the ROR companies comparable to the large companies price caps regulation was designed to accommodate. Even larger ROR ILECs, for example, generally serve a single urbanized area and surrounding rural territory far smaller than the major cities and huge geographic reach of the very large carriers for which the Commission has mandated incentive regulation.[5] Groups of commonly-owned small and rural ILECs scattered through many states share the same cost-of-service and serving conditions of small, independently-owned ILECs. Their affiliation with other small and rural carriers does not change the nature of the areas they serve and their customer bases. Such groups lack the economies of scale and scope available to the giant carriers made subject to mandatory price cap regulation.[6] Common ownership of such carriers simply does not change the service characteristics or economics of investing in and serving areas where traffic volumes are limited and the customer base over which costs must be spread is small. The resilience to economic instability and the economic buffer and business planning opportunities from serving vast areas with dense cores are simply unavailable to small and rural carriers. For example, the Commission has found that ROR

Telecommunications Act of 1996, CC Docket No. 98-146, *Third Notice of Inquiry*, FCC 01-223, ¶ 1, including n. 4 (rel. Aug. 4, 2001) (Broadband Inquiry).

[5] Small and midsized carriers were excluded from the Commission's price-cap mandate. *See Policy and Rules for Dominant Carriers*, CC Docket No. 87-313, 5 FCC Rcd 6786 at ¶ 106 (1990).

[6] See MAG Order at ¶ 86.

carriers "have fewer opportunities than large price cap carriers to achieve cost savings because of their limited size, their lumpy investment patterns, and fluctuating operating expenses."[7]

One of the central aims of the MAG access reforms was to provide regulatory policies "tailored to the needs of small and mid-sized local telephone companies serving rural and high-cost areas" that would "help provide certainty and stability for such carriers, encourage investment in rural America, and provide important consumer benefits." Suddenly forcing a carrier into a new regulatory mold during the five-year period of "stability" would have the opposite effect on its incentives to invest and could deprive the consumers it serves of the benefits of evolving network capabilities and services. Commissioner Copps has expressed it well: "It is essential that any regime we adopt increases certainty so that rural carriers can plan for the future and undertake necessary investment to modernize the telecommunications infrastructure in their communities."[8] In contrast, Commissioner Copps continued, exposing these carriers to more uncertainty would "imped[e] infrastructure investment and broadband deployment."[9]

The Associations are confident that suitable optional incentive regulation can be designed to encourage investment, maintain and improve service quality and stimulate deployment of new services, while maintaining ROR regulation for areas that cannot accommodate major change and achieve those goals. Indeed, another of the concerns the FNPRM voices is that the

> design of an alternative regulation plan must also address the incentives an alternative regulation plan gives rate-of-return carriers to reduce investment in plant and equipment, or to reduce expenditures on maintaining service quality, in

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[7] Ibid. As the Commission put it in 1993, small and midsize carriers had found they could not elect price caps regulation, in part, because with "their small size, their business cycles are too long to comply with price cap's annual adjustments and [ ] the financial effect of facility upgrades is too great to be reconciled with in the Commission's price cap framework." *Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation*, CC Docket No. 92-135, *Report and Order*, 8 FCC Rcd 4545 at ¶ 9 (1993).

[8] Separate statement of Commissioner Copps in response to FNPRM.

[9] Id.

order to increase profits at the expense of maintaining adequate investment or service quality.[10]

The Associations believe that adopting a plan that is optional for all carriers should be the Commission's single most important principle. Only an optional plan will modernize regulation where incentive regulation can benefit consumers as well as carriers, without jeopardizing the Act's commitments to comparable rural and urban services and prices or the availability of evolving capabilities in rural areas.[11] Those statutory objectives "clearly require[ ] investment in rural areas,"[12] and only an optional plan will optimize all ROR ILECs' incentives to achieve the goals set by Congress in their service areas, in spite of the enormous diversity of the group.

B. Since Affiliation Does Not Alter the Needs and Operating Challenges Faced by Each Individual Small or Rural Study Area, Any Incentive Plan Must Be Available on a Study Area Basis

The Associations agree with the Commission both that the all-or-nothing rules "should be addressed in the overall context of incentive regulation" and that "it would be beneficial to resolve the future status of the 'all-or-nothing' rule as expeditiously as possible."[13] Moreover, the review must go to the broad question of whether telephone service provided on a stand-alone basis to a discrete area and customer base should be regulated in the most efficient way for that study area and those customers. Just reading the Commission's discussion of the all-or-nothing issue and the comments it cites demonstrates that the Commission already has before it a full and compelling record justifying the immediate removal of its all-or-nothing rules as they apply both to price caps uniformity and uniformity of common line pooling status among study areas under common ownership. It is important for the Commission to look at this broader picture, moreover, rather than focusing solely on how the rules affect mergers and acquisitions. It is

[10] FNPRM at ¶ 223.

[11] 47 U.S.C. §§ 254(b), (c); 47 U.S.C. § 157 nt.

[12] FNPRM at ¶ 223.

[13] FNPRM at ¶ 265.

most efficient for each discrete operating area to qualify for the regulation and pooling status that best suit its conditions and characteristics. Yet the Commission should also rectify the current drastic rule impacts on acquisitions. Regardless of the characteristics of the affected study areas, today's rules generally deprive all affiliates of acquired price cap exchanges of both ROR regulation and pool eligibility unless they obtain waivers[14] typically conditioned on returning the price cap exchanges or companies to ROR regulation. The FNPRM cogently sums up the sound reasons parties advance for repealing the rules:

> (1)they are inefficient and unduly restrictive because they force carriers to choose a form of regulation that may not suit either their high-cost or low-cost affiliates; (2) there is insufficient evidence of cost-shifting to justify the rules; and (3) the Commission could rely on accounting safeguards and other non-structural mechanisms to prevent cost-shifting, as it does in other contexts.[15]

The proponents' pleadings cited in the FNPRM fully support those rationales.

It is beyond question that the all-or-nothing rules force the kind of inappropriate one-size-fits-all regulation Chairman Powell criticizes[16] on study areas and companies that are significantly different, regardless of resulting inefficiency or incentives to refrain from beneficial investments or to neglect the quality of service, or both. As noted, the facts of record here and in the proceedings considering and adopting the Rural Task Force recommendations demonstrate the differences among small and rural telephone companies and study areas. The holding companies that constitute groups of such study areas and carriers have repeatedly shown the Commission the differences among their ILEC study areas. The Commission has so routinely granted waivers to let acquired exchanges return to ROR regulation and reenter the National Exchange Carrier Association (NECA) Common Line pool that it is apparent that the speculative

[14] Parties to acquisition transactions often have to obtain waivers to the all-or-nothing rules in 47 C.F.R. §§ 61.41(b)-(c), 47 C.F.R. § 69.3, the study area freeze in the Part 36 Glossary and the "one-way" rule for becoming subject to price caps (47 C.F.R. § 61.41(d)), as well as the "one-way" rule for depooling (47 C.F.R. § 69.3(e)(4)).

[15] FNPRM at ¶ 265.

[16] *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, *Fourteenth Report and Order*, 16 FCC Rcd 11244, Separate Statement of Chairman Michael K. Powell (2001).

fears of gaming the system do not really warrant the rules.[17] Under the Access Charge Order, the Carrier Common Line element will be phased out by mid-2003, and Subscriber Line Charges are subject to prescribed caps. Thus, the risk of cost shifting between companies inside and outside the Common Line pool is not the driving force the Commission once thought it.

Moreover, recent transactions have demonstrated that forcing acquired price cap study areas back to ROR regulation because the rest of a company's study areas are not ready for price caps is not the optimal way to remedy the quality of service and repressed investment problems often encountered in price cap companies' rural areas. The Commission has expressly found, for example, that imposing a single productivity factor for Alltel's 22 states and diverse areas would be unacceptable.[18] More such acquisitions and anomalous results are certain to strain the Commission's resources as long as the Commission fails to do away with the all-or-nothing rules. Meanwhile, the Commission's unsatisfactory rules have forced it to leave the fate of Aliant and Puerto Rico Telephone Company hanging in the balance.[19]

The Commission's initial concern for price shifting between study areas, leading to the pooling all-or-nothing rule in 1987 was never more than a theoretical fear. Throughout their history, these rules have been aimed at the "risk" of cost shifting, not a demonstrated problem.[20] Cost shifting has not proved to be a problem, and there are strong safeguards to prevent or detect any abuses. Indeed, while the ultimate regulatory status of Aliant and Puerto Rico remains

[17] *See, e.g., Saddleback Communications And Qwest Corporation*, CC Docket No. 96-45, 2001 FCC LEXIS 6483, (2001); *All West Communications, Inc., Carbon/Emery Telecom, Inc., Central Utah Telephone, Inc., Hanksville Telecom, Inc., Manti Telephone Company, Skyline Telecom, UBET Telecom, Inc. And Qwest Corporation; Joint Petition for Waiver of the Definition of "Study Area" Contained in the Part 36 Appendix-Glossary of the Commission's Rules; Petition for Waiver of Sections 61.41(c), 61.41(d) and 69.3(e)(11)*, CC Docket No. 96-45, Order, 16 FCC Rcd 4697 (2001); *Sully Buttes Telephone Cooperative, Inc. and Qwest Corporation; Joint Petition for Waiver of Definition of "Study Area" Contained in Part 36, Appendix--Glossary of the Commission's Rules; and Sully Buttes Telephone Cooperative, Inc.; Petition for Waiver of Sections 61.41(c) and (d) and 69.3(e)(11) of the Commission's Rules*, CC Docket No. 96-45, Order, 15 FCC Rcd 18810 (2000).

[18] *Alltel Corporation; Petition for Waiver of Section 61.41 of the Commission's Rules and Applications for Transfer of Control*, 14 FCC Rcd 14941 at ¶ 25 (1999).

[19] Id. at ¶¶ 19, 28; *Puerto Rico Telephone Company; Petition for Waiver of Section 61.41 of the Commission's Rules and Applications for Transfer of Control*, 16 FCC Rcd 12343 (2001).

unsettled, the companies have been operating under different forms of regulation from their affiliates without any sign of cost shifting, gaming or any other abuse. Moreover, once a second court had reversed the Commission's earlier efforts to prevent common operation of incentive-regulated average schedule ROR companies and ROR companies that perform cost studies (cost companies) under common ownership,[21] that mixture of incentive ROR and pure ROR regulation would seem to have presented the same cost shifting incentives ever since the first cost and average cost company were commonly owned. However, the Commission has never demonstrated that cost shifting is a significant problem. Opponents' claims about predatory pricing and pool impacts, cited in the FNPRM (¶ 269), are also no more than theories and speculations. These concerns have also failed to materialize despite the Aliant/Puerto Rico experience. It is time to stop preventing efficient regulatory choices tailored to each study area's characteristics solely because of speculative concerns and to leave it to enforcement to find and root out specific infractions in the unlikely event that they ever occur.

In any event, there are sufficient regulatory safeguards to prevent or allow detection and correction, should any abuse occur. Many of the study areas under common ownership are separate corporate entities, often in different states. Not only is state regulation a safeguard, but state regulators are also particularly unlikely to overlook efforts to shift costs of operations outside the state into the rate base or expenses of a company they regulate. Interstate regulation also provides safeguards, including a number that were not in effect when the pooling and price cap all-or-nothing rules were adopted and upheld as properly balancing the risks and benefits of allowing affiliates with different regulatory or pooling status. ILECs are subject to the

[20] *See, National Rural Telecom Association v. FCC*, 988 F2d 174 (1993).

[21] The Commission tried to prevent common ownership of average schedule and ROR ILECs with a series of attempted justifications, including the presumption that affiliates could absorb costs for each other, that were struck down first in *National Association of Regulatory Utility Commissioners v. FCC*, 737 F.2d 1035 (1984) and then in *ALLTEL Corp. v. FCC*, 267 U.S. App. D.C. 253, 838 F.2d 551, 561 (D.C. Cir. 1988). Common ownership of

Commission's rules on accounting, separations, regulated vs. unregulated services and maintaining cost allocation manuals, affiliate transactions, tariffing requirements and complaints. Cost studies provided by pool members to NECA receive careful scrutiny.

Above all, the entire regulatory environment has changed since the Commission first imposed the pooling all-or-nothing rule in 1987, or even the price caps version 10 years ago. The balance of risks and benefits is profoundly different. The 1996 Act changed the national policy to embrace local competition and deregulation.[22] Wireless carriers are growing nationwide and are presenting a formidable competitive force in rural as well as urban areas. Wireless carriers have targeted even the most rural markets for entry and are obtaining designation as Eligible Telecommunications Carriers (ETCs) and sizable support payments.[23] There are simply no safe harbors to recover shifted costs. The record before the Commission and its experience over the years provide full justification for repealing the all-or-nothing rules for regulatory and pooling status. The Associations urge the Commission to do so without further delay.

III. NEW REGULATORY APPROACHES SHOULD NOT JEOPARDIZE EXISTING OPTIONS THAT HAVE SUCCESSFUL TRACK RECORDS IN DELIVERING HIGH QUALITY SERVICE TO COMMUNITIES SERVED BY SMALL AND RURAL ILECs

The Commission has recognized that the existing regulatory system has a successful record of meeting the challenges of providing nationwide service. The FNPRM states (¶ 224)

average schedule and ROR companies continued with no sign of abuse even after the Commission recognized in the ILEC price caps proceeding that average schedule regulation is a form of incentive regulation.

22 *Telecommunications Act of 1996*, Pub. LA. No. 104-104, 110 Stat. 56 (1996):

> An Act to provide for a pro-competitive, deregulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition, and for other purposes.

23 *See Multi-Association Group (MAG) Plan for Regulation if Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers, National Telephone Cooperative Association Petition For Reconsideration*, filed December 31, 2001 in CC Docket No. 00-256.

that "[r]ate-of-return regulation has worked well in extending service to rural America, along with our universal service program and the work of state commissions to support service in these areas." As the Commission develops a new alternative regulatory for carriers that are able to choose incentive regulation, it is nevertheless essential not to dismantle existing options that are working well, such as the choice between performing cost studies or relying on average schedules and the small-carrier option of filing two-year tariffs based on historical costs under §61.39 of the Rules.

A. The FCC Should Maintain Average Schedule and Cost Options for ROR Carriers

The Commission's existing regime permits carriers to elect either to perform cost studies or to set their rates based on the results. The more exacting demands of precisely identifying costs provide a clear path through the Commission's accounting, separations, regulated and unregulated cost allocations and tariffing rules to cost-based access charges. However, the Commission has also recognized that the cost and burden of performing full cost studies does not justify requiring all carriers to do so. Thus, average schedules, based on the actual costs of comparable carriers, have long been the basis for rates used by a sizable portion of the nation's small and rural ILECs.

As noted, when the Commission established price cap regulation for the large, urban-centered carriers, it also realized that average schedule regulation provides incentives for efficiency akin to price caps incentives. The Commission's rules, accordingly, already apply one form of incentive regulation to some ROR companies. That form of regulation should remain available and effective for ROR ILECs. The Commission should continue to allow both of these time-tested regulatory options for ROR carriers that cannot adopt a new form of alternative regulation.

B. The FCC Should Preserve, Fine-Tune and Extend §61.39, Which Provides Regulatory-Lag-Based Incentive Regulation and Some Flexibility for Some Small ILECs

The Commission has long been aware that small and rural ILECs are not immune from the pressures created by the rapid changes that characterize the telecommunications environment. Although in 1987 it created §61.39 simply as a way to decrease the administrative burdens on the smallest ILECs,[24] by 1993 the Commission recognized that the rule provides a valuable regulatory alternative, although additional choice was needed for some ROR ILECs:

> These smaller carriers face increased challenges on a number of fronts. Neighboring Bell Operating Companies compete for customers with new services and repackaged existing services. Changing regulatory requirements ... create new expectations from customers and increase the demand for quality service and responsiveness. Finally, new technologies, in particular those offered by neighboring exchanges, increase the LECs' need for regulatory flexibility and the ability to respond to competitive service offerings.[25]

Consequently, the Commission adopted an additional regulatory option (which only one carrier ever found itself able to adopt) and expanded the historic-cost-based, two-year tariff to apply to carrier common line rates as well.[26] Eligible companies' carriers were able to file tariffs every two years in lieu of participating in the NECA tariffs, using rates developed from the company's actual historical costs or historical average schedule settlements. The Commission specifically found that Section 61.39 had a record of success because its comparative review showed that §61.39 companies' rates had been consistently lower than NECA rates, while still remaining compensatory.[27]

The Commission should preserve §61.39's regulatory-lag-based incentives, reduced administrative burdens and costs, customer benefits and flexibility to establish rates closer to

[24] *Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation*, CC Docket No. 92-135, 72 RR 2d 1323, 8 FCC Rcd 4545, ¶ 2 (1993) (Regulatory Reform). The plan was limited to Subset 3 ILECs. See 47 C.F.R. § 69.602(a)(3).

[25] *Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, CC Docket No. 92-135, Order on Reconsideration*, 8 FCC Rcd 4545 (1993).

[26] Regulatory Reform at ¶ 14.

their own costs for ROR ILECs. Some adjustments may be necessary to keep §61.39 functioning properly in light of the MAG access reforms such as cost transfers out of the traffic sensitive rate elements. ILECs should be able to continue to elect §61.39 for either traffic sensitive or common line tariffs or both. To maintain the two-year tariffing impact on incentives, a carrier using §61.39 for its common line charges should freeze its ICLS collection on a per-line basis for each two-year period before it resets its rates based on historical costs.

At this time, the Commission should also remove its artificial restriction of §61.39 to subset 3 ILECs and ILECs with less than 50,000 access lines. It should also provide NECA the ability to use §61.39 for its traffic sensitive and common line tariffs. In its initial adoption of §61.39, again solely as administrative relief for small carriers, the Commission itself raised the size for a carrier to remain eligible to 50,000 because it was a study area-based size in use for universal service purposes. The Commission's only "explanation" for limiting the new methodology to subset 3 carriers was woefully inadequate: "We do not believe, however, that this small company exception should be extended to the largest carriers even if such carriers or groups of carriers have some small study areas."[28] It did not provide any reason at all for choosing subset 3 as the cut off, other than that "larger" companies had the resources to satisfy tariff burdens. Similarly, its only reason for rejecting NECA's request to use a like method for its tariffs was that NECA was more like a large than a small company.

Such arbitrary exclusion of affiliated companies or companies with an unexplained level of revenues would not pass judicial muster today, especially now that the Commission has recognized that §61.39 is a regulatory option, not just a small-company administrative relief measure. The D.C. Circuit reversed an earlier Commission decision where, as here, it had given no explanation of why the $40 million NECA Subset 3 cut-off controlled the ability of an

[27] Id. at ¶ 94.

affiliated small study area to comply with burdensome requirements.[29] The Commission did not reexamine the eligibility of non-subset 3 carriers in 1993 when it recognized the role of §61.39 as an incentive regulation plan, undoubtedly because it then adopted the plan that proved unsuited to all but one of the ROR companies not in NECA Subset 3. Nor did the Commission then reach the question of NECA participation because, at that time, NECA was seeking discretion to establish its own pool incentive plan. At this point, however, the Commission has had years of successful experience with §61.39, which is available on an individual study area basis, even to affiliated carriers with up to 50,000 lines, so long as the parent company does not exceed the arbitrary $40 million annual revenues benchmark. The history of §61.39 has not been one of significant problems. Indeed, the only case raising any concerns involved a very small company's accounting practices and was readily detected and rectified by the Commission in its normal tariff review process.[30]

The restriction of §61.39 historical cost filing and two-year review periods to Subset 3 companies with less than 50,000 lines has no basis in reason, facts or even economic theory. It is an opportunity to increase efficiency and reduce unnecessary regulatory costs for ROR companies that has worked well. Therefore, the Commission should maintain this option, which has proven itself beneficial for customers and carriers, for currently eligible ILECs, fine tune it as necessary to reflect the Access Charge Order and extend eligibility to all ROR ILECs and to NECA. There is simply no justification for denying a beneficial regulatory option to other carriers and customers that could benefit solely because the plan was originally proposed and adopted as a small company relief measure.

C. Any Incentive Plan Must Be Workable in a Pooling Context

[28] *Regulation of Small Telephone Companies*, CC Docket No. 86-467, *Report and Order*, 2 FCC Rcd 3811 at ¶ 9 (1987).

[29] *ALLTEL Corp. v. FCC*, 267 U.S. App. D.C. 253, 838 F.2d 551, 561 (D.C. Cir. 1988).

Even after the MAG access reforms, the value of sharing risks and administrative costs in healthy NECA pools will continue to be important to small carriers. That was one of the primary purposes behind the MAG proposals. The Associations believe that it is possible, as well as desirable, to develop and implement an incentive plan within the NECA pools that will provide the incentives the Commission is seeking for carriers that elect incentive regulation. We understand that NECA is filing comments that will discuss its ability and willingness to adapt the pool to an optional incentive plan. Such a plan would meet the Commission's goals, enable carriers that can justify incentive regulation to adopt a plan but remain in the pools and preserve a healthy pooling environment for carriers that are not able to elect incentive regulation and rely on the NECA pools.[31]

IV. THE COMMISSION SHOULD IMMEDIATELY GRANT PRICING FLEXIBILITY TO ROR ILECS, SO THAT HIGH-COST, RURAL CUSTOMERS ARE NOT SUBJECTED TO THE DETRIMENTAL IMPACTS OF INEQUITABLE PRICING CONSTRAINTS

The Associations strongly concur with the Commission that it is important for ROR ILECs to have pricing flexibility, so that they may be adequately prepared to respond to competition within their respective service areas.[32] As the telecommunications marketplace and technology have continued to evolve, the competitive threat for ROR ILECs has increased. New technologies will allow an increasing number of competing carriers to see profit potential in rural areas, and therefore include them in their service plans.

For instance, as wireless telecommunications technology has advanced, it has become a viable alternative to traditional wireline service for an ever-growing number of Americans, including those in rural areas. An increasing number of end-users are opting to use a wireless

[30] *Beehive Telephone Company, Inc.*, CC Docket No. 98-108, *Memorandum Opinion and Order*, 14 FCC Rcd 1224 (1998).

[31] The Associations also understand that NECA's comments will explain why the Commission should not rush to eliminate LTS on top of all the other changes it has recently adopted. The Associations urge the Commission to give great weight to NECA's expertise in issues involving pooling and access administration for ROR ILECs.

carrier as their primary provider of voice service.[33] In fact, over the next few years, it is predicted that a significant number of Americans will no longer subscribe to wireline phone service.[34]

As the Commission is well aware, a number of wireless carriers have been designated as eligible telecommunications carriers in rural service areas.[35] In contrast to the preconceived notion that new entrants are fragile and financially disadvantaged compared to the incumbent, in rural service areas competitors are often much larger in scale and in possession of far greater financial resources than the rural ILEC.[36]

The unique operating environments of rural service areas only serve to exacerbate the impact of competition. Typically, small, ROR ILECs provide service to only a handful of large businesses at most, which represent a significant portion of their access revenue streams.[37] Therefore, these carriers would lose a proportionately greater percentage of their revenues than would a price cap ILEC if a large customer were lost to competition.

[32] FNPRM, ¶247.

[33] According to a recent poll conducted by USA Today/CNN/Gallup, almost one in five cell phone users polled considered their wireless phone as their primary phone. *See, 18% See Cell Phones as Their Main Phones,* Michelle Kessler, *USA Today* (January 31, 2002).

[34] *Ibid.* According to Forrester Research, by 2006 approximately 2.3 million U.S. households will replace traditional wireline phones with wireless ones.

[35] For example, Western Wireless Corporation is an eligible telecommunications carrier in 13 states (California, Colorado, Iowa, Kansas, Minnesota, Nebraska, Nevada, North Dakota, Oklahoma, South Dakota, Texas, Utah, Wyoming, and the Pine Ridge Indian Reservation). Moreover, within these states Western currently offers competitive universal service in over 100 communities. *See,* Comments of Western Wireless Corp, filed Dec. 31, 2001, p. 2, in *Federal-State Joint Board on Universal Service Seeks Comment on Review of Lifeline and Link-Up Service for All Low-Income Consumers,* CC Docket No. 96-45, FCC 01-J-2 (rel. Dec. 31, 2001). Also, Western has ETC petitions pending in New Mexico and before the FCC for the Crow Indian Reservation, located in Montana. *See, Western Wireless Corporation Petitions for Designation as an Eligible Telecommunications Carrier and for Related Waivers to Provide Services for Universal Service Support to Crow Reservation, Montana,* Public Notice, CC Docket No. 96-45, DA 99-1847 (rel. September 10, 1999).

[36] For example, Western Wireless collected nearly $835 million in revenue during fiscal year 2000, had operating income of over $168 million, and total balance sheet assets of almost $2 billion. *See,* Western Wireless, Corporation, Fiscal Year 2000 10-K Report, Item 6, Selected Five-Year Financial Data (SEC filing date March 30, 2001). These financial results are well in excess of most independently owned rural telephone companies.

[37] FNPRM, ¶247. "On average, larger study areas, as measured by line size, typically have higher multi-line business customer density that smaller study areas. Average multi-line concentration increases consistently as the size of the study area group increases. The average rural carrier multi-line business share is 12 percent, compared to 21 percent for non-rural carriers." *See,* Rural Task Force White Paper 2: *The Rural Difference,* (Jan. 2000), p. 35.

While wireless competition targets residential users, multi-line, high-volume business customers are the prime targets of any other new market entrant. And, as the Commission acknowledged in the *1998 Notice*, the loss of high-volume customers would jeopardize the source of revenues that covers the costs of providing service to low-volume subscribers.[38] This would necessarily place pressure on ILECs to raise the rates of these low-volume subscribers, whom new entrants will often be uninterested in serving. Clearly, ROR carriers must be prepared to respond to competition, regardless of the form it may take.

The adoption of immediate pricing flexibility would allow ROR carriers to avoid the situation described above. Geographic rate deaveraging, volume and term discounts, and contract pricing would offer ROR carriers the flexibility necessary to adjust rates, in line with the capabilities of potential competitors. There is no reason why, for example, ROR ILECs should not be able to geographically deaverage their access rates, in order to more accurately reflect the differing costs of providing service to customers within their service areas. This is no different than the subscriber line charge deaveraging and universal service disaggregation that the Commission has already adopted and deemed to be in the public interest. Additionally, volume and term discounts would allow ILECs to offer nondiscriminatory price breaks to their best customers, while contract pricing would permit carriers to tailor services and rates to individual customer demands. As the Commission noted, these alternatives would make ROR carriers' pricing structures more efficient[39] and still fall short of the tools that competitors already have at their disposal.

When adopting pricing flexibility for ROR ILECs, it is imperative that carriers not be required to exit the NECA pools in order to obtain it. This is important for two reasons. First,

[38] *Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate of Return Regulation,* CC Docket No. 98-77, 13 FCC Rcd 14238, 14243, ¶12 (1998). (*1998 Notice*)
[39] FNPRM, ¶249.

small and mid-sized carriers should not have to give up the administrative and other benefits of the pool in exchange for the competitive benefits of pricing flexibility. Second, as it is quite likely that low-cost pool participants would have the greatest incentive to leave the pool to take advantage of pricing flexibility, the long-term viability of the pool itself would be threatened were such a choice required.

NECA has indicated that the pooling process can accommodate pricing flexibility. Already, the present form of rate banding permits NECA to establish multiple rates for the same access rate elements within the pooling process. In addition, NECA has stated that it could modify its settlement and rate setting mechanisms on a targeted basis to narrower groups of companies without undue hardship. Therefore, the Commission should allow NECA to develop the necessary administrative procedures that would provide ROR carriers with the ability to more accurately target rates to zones and customers within the pooling environment.

Pricing flexibility should not be conditioned on the existence of some level of competition. In order to effectively compete against new entrants, who often bring greater resources to bear than the incumbent, ROR ILECs need the immediate ability to employ all forms of pricing flexibility. By conditioning the provision of pricing flexibility upon some sort of competitive criteria, such as the loss of customers, the Commission would place ROR carriers at risk of losing the very revenue streams that they rely on to support, in part, the costs of service to low-volume residential users. Without explicit support to make up the difference, such a development could threaten the historically high penetration levels in rural areas.

Should the Commission still be compelled to consider the adoption of competitive triggers, it must be certain that the standard adopted does not withhold pricing flexibility until a competitive entrant has seriously undermined the ROR ILEC's continued viability as the carrier of last resort. As the Commission itself recognizes, the competitive triggers that have been adopted for price cap carriers are indeed too restrictive for smaller ROR carriers.[40] ILECs should be provided with a real opportunity to compete before it is too late. Furthermore, the Commission should also provide that the "trigger" can be activated by the entry of more than just wireline competition. In order to be technologically neutral, ROR ILECs should become eligible for pricing flexibility upon the entry of any competitor, regardless of the technology employed. By leveling the playing field between incumbents and competitors, the potential customers of either carrier are the ultimate beneficiaries through access to a marketplace that sustains universal service within a competitive environment.

V. CONCLUSION

The Associations commend the Commission for its sensitivity to the diversity among ROR ILECs and the importance of not jeopardizing service and network improvements for their customers. Consistent with the paramount importance of developing rules that respond to dramatically varying needs and conditions of service, the Associations respectfully urge the Commission to ensure that:

- Any plan for alternative regulation is entirely optional to accommodate the diversity and the resulting readiness of some areas, but not others, for incentive regulation and preserve sound incentives for investment and maintaining quality of service;

- Any alternative regulatory plan is optional on a study-area-by-study areas basis for affiliated carriers to reflect the dramatic changes in law, regulations, customer needs and market facts since the all-or-nothing rules for pooling and price caps were adopted;

- Any alternative regulation plan does not undermine or eliminate regulatory options that have helped make rural service universal under ROR regulation and will remain necessary for carriers that cannot elect an incentive plan -- including the option to perform cost studies or rely on average schedules, the successful regulatory-lag-based §61.39 plan, which should be available to all ROR carriers and study areas and to NECA;

- Any alternative regulation is consistent with maintaining sound and effective NECA pools; and

[40] *Id.*, ¶257.

- ROR ILECs obtain sufficient regulatory flexibility <u>in time</u> to enable them to compete in light of marketplace changes and their extreme dependence on retaining their few high-volume business customers – <u>before</u> competition with inadequate flexibility has seriously impaired their ability to continue as carriers of last resort.

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